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When Doves Cry, "Not Yet"

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Key Points

- The Fed surprised markets and opted not to taper its QE program; while stocks and bonds rallied sharply
- The Fed also lowered its economic forecasts for the third time this year
- Uncertainty remains; not only about the timing of tapering, but also about the next Fed chair.

The Fed surprised markets and moved against consensus…by not moving at all. The decision by the Federal Open Market Committee (FOMC) was to leave its $85 billion monthly bond buying program intact: "Taking into account the extent of federal fiscal retrenchment, the Committee sees the improvement in economic activity and labor market conditions since it began its asset purchase program a year ago as consistent with growing underlying strength in the broader economy. However, the Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases." Expectations (including ours) were that they were likely to taper purchases by a mild $10 billion or so.

Kansas City Fed President Esther George dissented for the sixth consecutive meeting, repeating that maintaining the current pace of purchases risks creating financial imbalances.

Higher rates came into play

In referencing "tightening of financial conditions" in the statement accompanying the meeting, the Fed made it clear that the recent back-up in long-term interest rates, including mortgage rates, was a key reason for holding off on tapering. In essence the Fed may be sending a signal that the bond market over-reacted when the 10-year yield spiked to nearly 3%.

The Fed also downgraded its outlook for the economy; so it's also likely that they opted not to taper so as not to contradict their less optimistic forecast. In other words, they might have had a difficult time justifying a taper, which would have suggested more economic optimism, while also lowering their economic assumptions.

Guidance lowered ... again

The Fed now sees the economy growing in 2013 in a range of 2.0-2.3%. The earlier forecast had predicted growth of 2.3-2.6%. For 2014 the Fed is now forecasting 2.9-3.1% (down from 3.0-3.5%), and for 2015 the forecast is 3.0-3.5% (tightening up the prior range of 2.9-3.6%). The unemployment rate and inflation thresholds were not changed, although the estimated long-term sustainable unemployment rate was slightly lowered from 5.2-6.0% to 5.2-5.8%.

Inflation, which has lately taken a back seat to unemployment, may have also been a factor in the Fed's decision. Core inflation is running at a low 1.2%; which is near the discomfort zone and well below the Fed's 2% threshold.

Fixed income considerations

Kathy Jones, Schwab's fixed income strategist, also weighed in that concerns about tighter fiscal policy also seemed to play a role in the decision; and that estimating 2016's Fed funds rate at 2% implies low short-term rates for several more years. She and her team believe the 10-year Treasury yield will probably fall back toward 2.5% or so; but that we also now go back to watching every employment report for signs of strength or weakness. Short-term rates are likely on hold for a lot longer than many thought; and will rise slowly when tightening begins.

Lingering uncertainty

What we now face is a lingering of uncertainty regarding the timing of tapering; which means the sharp rally induced by the announcement, could run into trouble at some point. Don't get me wrong- I remain very optimistic about the stock market; but the hope that this was going to be the lifting of one of many uncertainties has clearly not panned out. And of course, we still have the uncertainty surrounding the new Fed chair.

There's already a conversation beginning whether the decision- or lack thereof- was partly driven by the possible announcement of Janet Yellen as Fed Chair Ben Bernanke's replacement. Yellen is considered quite dovish (errs on the side of looser monetary policy); and if the Fed were to begin the normalization process, it would clip the dove's wings a little. In addition, the rotation of FOMC voting members into 2014 will likely result in a more hawkish (errs on the side of tighter monetary policy) membership.

For now…

… enjoy the rally.